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Finance Alert

Newly Adopted LCR Rules Supplement Existing Liquidity Management Rules for Larger Banks and Bank Holding Companies

On September 3, 2014 the Federal Reserve Board (Board), the Office of the Comptroller of the Currency (Comptroller) and the Federal Deposit Insurance Corporation adopted a set of rules (LCR Rules) regarding the calculation and maintenance of a liquidity coverage ratio (LCR) based on standards agreed upon by the Basel Committee on Banking Supervision.[1] The LCR Rules apply only to larger banks and bank holding companies and supplement, rather than replace, the more generally applicable rules regarding liquidity management.[2] In addition, the requirements of the LCR Rules are more formulaic or arithmetical in their application than are the rules they supplement, which constitute prudential guidelines.

To achieve their desired result, all LCR rules of any kind need to resolve certain issues:

- The institutional scope of the rules' application;
- The timing of their implementation;
- The identification of the kinds of assets that will be treated as liquid;
- The determination of the need for liquidity and the degree to which the need must be covered; and

1 "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards." The liquidity standards agreed upon by the Basel Committee ("Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tool") can be found here.

2 See the Board's Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240 (Mar. 27, 2014), and the various types of more broadly applicable regulatory guidance previously issued about the management of liquidity risk.

- The adaptation of the measured need for liquidity to stress and other variations in need over the applicable time period.

The LCR Rules as adopted present themselves as a resolution of all these issues.

Scope of the Rules' Application

The LCR Rules are intended to reduce the risk that complex financial institutions will fail if in a financial crisis the financial markets do not make adequate liquidity available to them. This aim is coupled with the belief that the liquidity needs and practices of large, complex institutions are harder to manage and supervise than those of smaller institutions as well as the concern that the failure of one or more large institutions would significantly affect financial and other markets in the US.

As a result of these considerations, the more stringent provisions of the LCR Rules apply only to:

- Bank and savings and loan holding companies with either total consolidated assets of $250 billion or more, or total on-balance sheet foreign exposure[3] of $10 billion or more;
- Consolidated depository institution subsidiaries of such holding companies that have total consolidated assets of $10 billion or more; and
- Any other institution to which the applicable federal banking agency decides to apply the LCR Rules, based on its assets, complexity, risk profile, operations, affiliation with entities already subject to the LCR Rules and potential for endangering the financial system in a liquidity crisis.

A modified version of the LCR Rules will apply to bank and savings and loan holding companies domiciled in the US with total consolidated assets of $50 billion or more but less than $250 billion and that are not internationally active. Such banks are considered less difficult to manage and supervise and are permitted to calculate their LCR using a deemed net cash outflow rate[4] that equals 70 percent of the rate that a larger institution would use under the same circumstances.

A savings and loan holding company that satisfies the above requirements (whether modified or unmodified) is nevertheless excluded from the application of the LCR Rules if it is a grandfathered unitary holding company that, "as of June 30 of the previous calendar year, derived 50 percent or more of its total consolidated assets or 50 percent of its total revenues on an enterprise-wide basis (as calculated under GAAP) from activities that are not financial in

3 Defined as "total cross-border claims less claims with a head office or guarantor located in another country plus redistributed guaranteed amounts to the country of the head office or guarantor plus local country claims on local residents plus revaluation gains on foreign exchange and derivative transaction products, calculated in accordance with the Federal Financial Institutions Examination Council (FFIEC) 009 Country Exposure Report." See §__.1(b)(ii) of the Common Rules (i.e., the LCR Rules adopted as jointly applicable by the adopting agencies).

4 A measure of an institution's need for liquidity, discussed below. Since the outflow rate is the denominator of the LCR, the numerator, which indicates the institution's stock of liquidity, can also be smaller and still lead to the calculation of a satisfactory LCR.

nature…"[5] Also excluded are top-tier depository institution holding companies that underwrite insurance or have insurance underwriting subsidiaries that constitute 25 percent or more of their total consolidated assets (calculated according to GAAP).

Based on their current asset sizes, US branches and agencies of non-US banks will not be subject to the LCR Rules; furthermore, the LCR Rules will not apply to the other US operations of non-US banks, including any intermediate holding companies they may be required to establish. The Board states in the LCR Release, however, that it "anticipates implementing an LCR-based standard through a separate rulemaking for the US operations of some or all foreign banking organizations with $50 billion or more in combined US assets."[6]

In addition, the LCR Rules will not apply to institutions that have opted to apply the advanced approaches risk-based capital rules but do not otherwise meet the size requirements for their application.

Institutions designated as systemically significant by the Financial Stability Oversight Council will not be subject to the LCR Rules but will instead ultimately be required to satisfy special rules more closely tailored to their specific businesses. Consolidated depository institution subsidiaries of such companies will, however, be subject to the LCR Rules if they have at least $10 billion in consolidated assets and are either state non-member banks or state savings associations; if they are national banks or federal savings associations, the Comptroller will make an individualized determination as to the application of the LCR Rules.

Timing of Implementation

The timing of the implementation of the LCR Rules further differentiates among the various institutions that are affected. The differentiation reflects the view that the largest institutions both could cause greater harm to the financial system than the smaller ones if they were ever subject to a liquidity crisis and are more capable of implementing the LCR Rules more quickly. Covered depository institution holding companies with at least $700 billion in total consolidated assets or $10 trillion in assets under custody and depository institutions with at least $10 billion in total consolidated assets that are themselves consolidated subsidiaries of such holding companies must begin calculating their LCR on the last business day of January 2015 and on the last business day of each subsequent month through June 30, 2015. Thereafter, they must compute their LCR on each business day. All other covered companies must calculate their LCR on the last business day of the month from January 2015 through June 2016; from then on, daily calculations are required. During 2015 covered companies must only satisfy 80 percent of the full LCR requirement, regardless of the frequency with which they must calculate that value. The percentage rises to 90 percent in 2016 and to 100 percent thereafter.

5 Section __.3 of the Common Rules, definition of "covered depository institution holding company."
6 LCR Release, p. 32.

Bank holding companies with more than $50 billion but to which the LCR Rules do not apply never have to calculate their LCR; instead, they are subject to a modified LCR rule (Modified LCR Rule) that requires the calculation of a modified LCR (Modified LCR) on the last business day of each month, beginning in January 2016. Through December 2016, a bank holding company subject to the Modified LCR Rule must maintain a Modified LCR equal to 0.90; thereafter, its Modified LCR must equal 1.0. The ways in which the Modified LCR differs from the otherwise applicable LCR are discussed below.

Identifying Liquid Assets

For purposes of the LCR Rules, covered institutions must actually hold liquid assets, since the premise of the Rules is that such institutions might not have access to market liquidity on acceptable conditions in a short period of extreme stress. Similar considerations lead to the conclusion that liquid assets are those that can easily be sold and maintain their value during such a period. Treating assets as liquid that do not retain their value under conditions of market stress would lead to an overvaluation of an institution's stock of liquidity; by the same reasoning, such assets would not be acceptable to other market participants as near cash equivalents.[7]

The LCR Rules represent an effort to treat a fairly wide range of assets as liquid while still distinguishing them in terms of their usefulness for this purpose. To qualify, securities must be liquid and readily marketable, which is defined to mean "traded in an active secondary market with: (1) [m]ore than two committed market makers; (2) [a] large number of non-market maker participants on both the buying and selling sides of transactions; (3) [t]imely and observable market prices; and (4) [a] high trading volume."[8]

The distinctions among different types of liquid assets are effectuated by restricting the degree to which assets considered less liquid may be counted as part of the stock. The restrictions come in two forms: (i) something that amounts to a haircut with respect to their value (15 percent for Level 2A liquid assets and 50 percent for Level 2B); and (ii) limitations on the extent to which Level 2A and 2B liquid assets can be used to supplement Level 1 assets in the calculation of the amount of "high quality liquid assets" held by an institution.

Given these definitional and arithmetical relationships, the agencies have classified liquid assets as follows:

- **Level 1 liquid assets** include reserve bank balances, foreign withdrawable reserves, securities issued or unconditionally guaranteed by the US Treasury, securities issued or guaranteed by any other agency of the US government (so long as they are backed by the full faith and credit of the government), securities issued or guaranteed by a sovereign entity, the

7 The agencies refer to the relevant characteristics as "(a) risk profile, (b) market-based characteristics, and (c) central bank eligibility." LCR Release, p. 42.
8 Section __.3 of the Common Rules.

Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Community or a multilateral development bank;[9]

- **Level 2A liquid assets** include securities issued or guaranteed by a government-sponsored enterprise that are investment grade and senior to preferred stock, certain securities issued or guaranteed by a sovereign entity or multilateral development bank;[10] and
- **Level 2B liquid assets** include certain corporate debt securities[11] and certain widely-traded common equities.[12]

The specific definitional requirements contained in the footnotes regarding Level 2A and 2B liquid assets exemplify the kinds of factors relevant to deciding whether an asset should be treated as liquid. One type of asset currently omitted from the liquid category is securities issued by states and municipalities, on the grounds that some securities of this type are not actively traded. Given that active trading is part of the definition of "liquid and readily marketable," it is somewhat unclear why municipal securities that happen to meet that generally applicable requirement were not treated as liquid assets. Perhaps the agencies considered the available information on market depth to be too dispersed to permit a simple characterization of the municipal securities that are sufficiently liquid. The discussion in the Preamble to the LCR Release makes it clear that the agencies consider credit quality much less important than trading depth for these purposes.[13] "[A]sset-backed securities (ABS), state and local authority housing bonds backed by Federal Housing Association and Department of Veterans Affairs guarantees, covered bonds, private label MBS, and investment company shares … permissible collateral pledged to FHLBs, FHLB letters of credit, and unused borrowing commitments from FHLBs"[14]

9 But only if the securities are "(i) [a]ssigned a zero percent risk weight under subpart D of [AGENCY CAPITAL REGULATION] as of the calculation date; (ii) [l]iquid and readily-marketable; (iii) [i]ssued or guaranteed by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; and (iv) [n]ot an obligation of a financial sector entity and not an obligation of a consolidated subsidiary of a financial sector entity; …" §__.20(a)(5) of the Common Rules. Securities issued by a sovereign entity that are not assigned a zero percent risk weight are nevertheless Level 1 liquid assets if "the sovereign entity issues the security in its own currency, the security is liquid and readily-marketable, and the [BANK] holds the security in order to meet its net cash outflows in the jurisdiction of the sovereign entity…." §__.20(a)(6) of the Common Rules.

10 Namely, securities that are not level 1 liquid assets, have no more than a 20 percent risk weight for capital purposes, are issued or guaranteed by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions and are not an obligation of a financial sector entity, and not an obligation of a consolidated subsidiary of a financial sector entity. §__.20(b)(2) of the Common Rules.

11 In particular, those that are treated as investment grade under the Comptroller's investment securities regulation, issued or guaranteed by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, and are not an obligation of a financial sector entity and not an obligation of a consolidated subsidiary of a financial sector entity. §__.20(c)(1) of the Common Rules.

12 Those that are included in the Russell 1000 Index or a similar foreign index approved by a foreign regulator if the shares are held in the regulator's jurisdiction; are issued in U.S. dollars or, if not, the currency of a jurisdiction where the covered institution operates, provided it holds the common equity share in order to cover its net cash outflows in that jurisdiction; issued by an entity whose publicly traded common equity shares have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; are not issued by a financial sector entity and not issued by a consolidated subsidiary of a financial sector entity; if held by a depository institution, is not acquired in satisfaction of a debt previously contracted; and if held by a consolidated subsidiary of a depository institution, can be included in the institution's level 2B liquid assets only if the shares are held to cover net cash outflows of that consolidated subsidiary. §__.20(c)(2) of the Common Rules.

13 The memorandum of Board staff to the Board regarding the LCR Rules recommends, however, that a new proposal be developed that would count the most liquid municipal securities as HQLA.

14 LCR Release, p. 86.

were also not treated as liquid assets. Neither were securities issued by public sector entities at the state or municipal level.

In addition, securities issued by financial sector entities and their consolidated subsidiaries are also excluded, on the grounds that in a financial crisis they are more likely to be affected than the securities of non-financial entities.

Not only must these definitional requirements be satisfied if a liquid asset is to be treated as HQLA, but operational requirements must be met as well. Procedures must be established to monetize such assets periodically, as a check on their actual market liquidity; management must demonstrate that it has control over the liquid assets by either segregating them or demonstrating an ability to monetize the assets and make the proceeds available to the liquidity managers without running afoul of a business or risk management strategy of the institution.

Measuring the Need for Liquidity

The need for liquidity must somehow be measured if it is to be considered covered by the liquid assets described above. The degree of coverage is represented by the LCR, which is defined as the ratio of the institution's HQLA to its total net cash outflow. The LCR Rules measure the need by computing the net cash outflow (i.e., the denominator of the LCR), which equals the net (positive) value of the daily contractually agreed or deemed inflows and outflows over the 30-day measurement period, and then adding an adjustment (referred to as a "maturity mismatch add-on") which equals (i) the greater of zero and the net outflow for the day in that period that has the largest cumulative[15] net outflow[16] based on only inflows and outflows that have set maturity dates ***minus*** (ii) the greater of zero and the net outflow for the 30th day.

Although the aggregate net cash "outflow" could theoretically be an inflow (i.e., negative outflow), two factors combine to make that virtually impossible. First, the inflow amount that is subtracted from the outflow amount is the ***lesser*** of the actual inflow or 75 percent of the outflow amount.[17] This guarantees by itself that the computed net outflow amount will not be negative. Second, the maturity mismatch add-on (which does not use the 75 percent multiplier) will in most cases further increase the computed net outflow amount, and can never decrease it.[18] As a result of these measurement conventions, there should always be a surplus of HQLA

15 A cumulative net outflow for a date is the difference between the sum of the outflows up to and including that date minus the sum of the inflows up to and including that date.

16 In other words, deemed inflows and outflows are not counted for this purpose.

17 Note that inflow amounts do not include the amount of any credit or liquidity facility extended to the institution performing the LCR calculation. Section __.33(a)(3) of the Common Rules.

18 The same factors also make it virtually impossible for the denominator of the LCR to be zero, which would result in an undefined or infinite LCR. A zero denominator could only arise in a completely implausible situation, namely one in which for a 30-day period an institution had no contractual or deemed outflows, with the result that 75 percent of zero would be zero. This aspect of the LCR suggests, however, that it might be easier for an institution to improve its LCR by reducing its outflows, which could have the potentially undesirable effect of reducing market liquidity. Note that the way the mismatch add-on is calculated in effect favors three kinds of structures, those in which the net outflow is always zero or negative (i.e., there is a net inflow), those in which there are two days on which maximum cumulative net outflow occurs, one of which is the 30th day, and those in which the date with the largest net outflow is also the 30th day of the calculation period, since in all of these events the add-on will equal zero. This result

over the anticipated net outflow that would be available to handle unexpected liquidity needs. This surplus is in addition to the amounts likely to result from the haircuts discussed above and the fairly conservative deemed outflow rates discussed below.

The amount of HQLA that is treated as available to cover this outflow (i.e., the numerator of the LCR) is calculated by adding the Level 1, 2A and 2B liquid assets together and then reducing the amount of the total Level 2 liquid assets so that they do not exceed 40 percent of the total amount of HQLA and reducing the Level 2B liquid assets so that they do not exceed 15 percent of the total amount of HQLA. As discussed below, this basic calculation is subject to further adjustment to account for the unwinding of certain transactions over the 30-day calculation period.

In identifying the inflows and outflows that must be counted in a given 30-day period, the provisions in the LCR Rules regarding the determination of maturity dates can be vital, since if there are either no maturity dates at all or contractual options as to maturity dates, these provisions fix the date on which the relevant flow will be treated as taking place. For example, in the case of outflows, the applicable investor is assumed to accelerate a maturity date and is assumed not to extend the maturity date, if either of those is an option. The covered institution is, with one exception, also assumed to exercise any option to accelerate the maturity date of an outflow and not to exercise any option to extend. Conversely, for inflows the latest possible date is treated as the applicable date for both the covered institution and the borrower. The latest date is assumed for certain cash payments on secured loans and returns of assets that have been part of an asset exchange. Certain types of wholesale funding with no maturity date are assumed to mature on the first day after the calculation date; other types are assumed to mature within the 30-day calculation period.

The last fundamental factor affecting the calculation of the LCR is the choice of deemed inflow and outflow values, since these values reflect regulatory expectations of flow likelihoods during a period of stress in connection with financial arrangements, such as commitments and deposits, that do not have contractually fixed disbursement or repayment dates. If those expectations are not approximately accurate, they can either unnecessarily restrict banking or fail to reduce the risk of a liquidity crisis.

Which inflow and outflow assumptions are most important for a given institution will depend on the kinds of business that are most important to it. For institutions that develop structured financial products the following assumptions may be among the most relevant:

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of applying the mismatch add-on in its current version appears to be a side effect of the smoothing that results from using a cumulative measure, rather than the more erratic measure that was originally proposed, which used the largest single daily outflow as the basis for adjustment.

- *Structured transactions:*[19] The institution that sponsors a structured transaction for which the issuer is not consolidated with the institution must treat as the outflow amount the greater of (i) 100 percent of the amount of issuer's debt that becomes due within 30 days and the issuer's commitments to purchase assets within 30 days, and (ii) the maximum amount the institution must contractually provide to the issuer within that 30-day period under a liquidity facility, asset purchase or other funding arrangement.
- *Commitments:*
  - 30 percent of any undrawn amounts[20] under committed liquidity facilities extended to a non-retail customer that is a non-financial sector entity,[21] including a special purpose vehicle that is consolidated with the institution;
  - 40 percent of undrawn amounts under committed credit facilities extended to a financial sector entity or a consolidated subsidiary thereof (including special purpose entities other than those described immediately below);
  - 100 percent of any undrawn amounts under committed credit and liquidity facilities extended to special purpose entities that issue commercial paper or other securities (other than nominal equity); and
  - 100 percent of any undrawn amounts under committed **liquidity** facilities extended to financial sector entities or consolidated subsidiaries thereof (including special purpose vehicles).[22]
- *Secured lending:* Reverse repurchase agreements are treated as secured lending and are assigned deemed inflow percentages between zero and 100 percent, depending largely on the

19 "…a secured transaction in which repayment of obligations and other exposures to the transaction is largely derived, directly or indirectly, from the cash flow generated by the pool of assets that secures the obligations and other exposures to the transaction." Section __.3 of the Common Rules, definition of "structured transaction."

20 For these purposes, undrawn amounts that could be drawn within 30 days minus, under some circumstances Level 1 and Level 2A assets securing the facility.

21 "…an investment adviser, investment company, pension fund, non-regulated fund, regulated financial company, or identified company." Section __.3 of the Common Rules, definition of "financial sector entity." An identified company is any other kind of company that the applicable federal banking regulator decides should be treated like a financial sector entity. A regulated financial company is a depository institution holding company, company designated as systemically significant by the Financial Stability Oversight Council, depository institution, subsidiary of a holding company subject to the LCR Rules, foreign bank, credit union, a non-deposit-taking bank, insurance company, securities holding company, futures commission merchant, swap dealer, securities-based swap dealer, designated financial market utility, and similarly regulated non-US companies, but excluding US government-sponsored entities, small business investment companies, community development financial institutions, central banks, the Bank for International Settlements, the International Monetary Fund and multilateral development banks.

22 In order to avoid double counting, certain amounts are excluded from the two deemed 100 percent outflow calculations described here. Both of them exclude commitments relating to liquidity facilities in structured transactions. The 100 percent deemed outflow for liquidity facilities extended to financial sector entities also excludes commitments by depository to affiliated depository institutions that are also subject to the LCR Rules as well as commitments to depository institution holding companies, foreign banks and depository institutions other than those that are affiliated and subject to the LCR Rules. Note that the structured transaction provisions relate to deemed outflows to unconsolidated entities. The Preamble addresses this point as follows: "If the issuing entity is consolidated with the covered company, then the commitments from the covered company to that entity would be excluded under section .32(m) as intragroup transactions. However, even though the commitments would be excluded, any outflows and inflows of the issuing entity would be included in the covered company's outflow and inflows because they are consolidated." LCR Release, pp. 164-5.

kinds of assets securing the agreements (HQLA or not; Level 1 or 2A or not) and whether the assets have been rehypothecated.

- *Intragroup transactions* are excluded from calculations of inflow and outflow.

The calculation of the Modified LCR differs in the following ways from the calculations described above:

- There is no maturity mismatch add-on, since there are no daily calculations;
- The amounts of all deemed outflows (i.e., those without a contractual outflow date) equal 70 percent of those that would apply under the regular LCR Rules;
- Net outflow is calculated by subtracting the **lesser** of the inflows otherwise calculated or 75 percent of the amount described in the immediately preceding bullet point.

Adjusting the Need for Liquidity to Handle Variation

In addition to the kinds of calculations described above, the amount of HQLA eligible for inclusion in the numerator of the LCR is further adjusted for certain other kinds of changes that may occur over the 30-day computation period. The LCR Release describes the basic motivation for this adjustment:

> The agencies believed that the proposed Level 2 caps and haircuts should apply to the covered company's HQLA amount, both before and after the unwinding of certain types of secured transactions, where eligible HQLA is exchanged for eligible HQLA in the next 30 calendar days, in order to ensure that the HQLA amount is appropriately diversified and not the subject of manipulation. The proposed calculation of the adjusted excess HQLA amount on this basis sought to prevent a covered company from being able to manipulate its eligible HQLA by engaging in transactions such as certain repurchase or reverse repurchase transactions because the HQLA amount, including the caps and haircuts, would be calculated both before and after unwinding those transactions.[23]

To effectuate this purpose, the formula for calculating adjusted liquid asset amounts takes into account the unwinding of "any secured funding transaction (other than a collateralized deposit), secured lending transaction, asset exchange, or collateralized derivatives transaction that matures within 30 calendar days of the calculation date where the [covered institution] will provide an asset that is eligible HQLA and the counterparty will provide an asset that will be eligible HQLA."[24] The formula then compares the excess Level 2 liquid assets (i.e., the Level 2 liquid assets that exceed 40 percent and 15 percent of the total eligible HQLA) as calculated on the calculation date to the excess Level 2 liquid assets as calculated after taking into account the probable results of the relevant unwindings. The greater of the two amounts (ignoring any negative amounts) is then subtracted from the total HQLA amount as calculated for the

23 LCR Release, p. 123.
24 Section __.21(f)(1) of the Common Rules.

calculation date. Under the most common circumstances, it seems likely that the subtraction of the greater of the two amounts will likely do no more than reduce the amount of Level 2 liquid assets counted as part of the numerator of the LCR. Despite the apparent intentions expressed in the indented paragraph above, however, in the very unlikely event that the excess Level 2 liquid assets are disproportionately larger than the Level 1 assets as of the 30th day, the subtraction could potentially also reduce the amount of Level 1 liquid assets included in the numerator, even if the amount of Level 1 liquid assets has not changed between the two dates. The LCR Rules are quite clearly a pragmatic attempt to find measurements and methods that will work in the majority of cases, rather than attempts at an impossible perfection.

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